Corporate Governance and Compliance

Corporate Governance Defined

Good corporate governance consists of a system of structuring, operating and controlling a company such as to achieve the following:

- a culture based on a foundation of sound business ethics
- fulfilling the long-term strategic goal of the owners while taking into account the expectations of all the key stakeholders, and in particular:
  - consider and care for the interests of employees, past, present and future
  - work to maintain excellent relations with both customers and suppliers
  - take account of the needs of the environment and the local community
- maintaining proper compliance with all the applicable legal and regulatory requirements under which the company is carrying out its activities.

From Applied Corporate Governance Website

Corporate Governance and Compliance

Sources of Corporate Governance Requirements

- Historically Mostly Matter of Best Practices – Not Codified in Laws or Regulations
- Historic Paradigm
  - State Corporate Law Governs Internal Corporate Affairs
  - Federal Securities Laws Govern Issuance and Secondary Trading of Corporate Securities
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Sources of Corporate Governance Requirements

– State Corporate Law
  • Generally few specific state corporate law governance requirements
    › S/H act on fundamental changes
    › For instance, amendment to charter, mergers, sale of substantially all assets, dissolution, etc.
    › BoD responsible for the direction of the management of the business and affairs of corporation
      › Act on fundamental changes, appointment of officers, issuance of stock, etc.
    › Fiduciary duties of loyalty and care
    › Delegation of authority for day-to-day management to directors

– Federal Securities Laws
  • Securities Act of 1933 (‘33 Act or Securities Act)
    › Sale of securities by or on behalf of issuer
  • Securities Exchange Act of 1934 (‘34 Act or Exchange Act)
    › Regulation of secondary trading markets
    › General anti-fraud provisions
    › Public company periodic disclosures
    › Public company proxy rules
    › Williams Act (added in 1968)
      › Stock accumulation rules
      › Tender offer rules

– After Early 2000s Corporate Scandals – Highly Codified
  • SOX, SEC regulations and stock exchange listing requirements
  • Director independence definitions and requirements
    › Independence determined by board subject to specified disqualification criteria
    › No material relationship with company (commercial, industrial, banking, consulting, legal, accounting, charitable or family)
    › Disclosure of identity of independent directors and of basis for determining independence
  • Specified board and committee activities
    › Non-management directors must meet in regularly scheduled executive sessions
    › And independent directors meet in executive session at least once per year
    › Introduces concept of presiding or lead director
Corporate Governance and Compliance
Sources of Corporate Governance Requirements
– After Early 2000s Corporate Scandals – Highly Codified
  • Required committees with specified composition
    » Nominating/Corporate Governance
    » Compensation
    » Audit
    » Additional independence criteria for members
    » All members financially literate and one audit committee financial expert
  • Disclosure of Corporate Governance Guidelines
    » Independence standards
    » Director qualification standards, responsibilities and orientation and continuing education
    » Director access to management and independent advisors
    » Director compensation
    » Management succession
    » Annual board performance evaluation

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Sources of Corporate Governance Requirements
– After Early 2000s Corporate Scandals – Highly Codified
  • Codes of Conduct
    » Disclosure of code of ethics for principal executive, financial and accounting officers and, if none adopted, explain why not
    » Disclosure of code of conduct for directors, officers and employees
      » Conflicts of interest
      » Corporate opportunities
      » Confidentiality
      » Fair dealing
      » Protection and proper use of company assets
      » Compliance with laws (including insider trading)
      » Reporting of illegal or unethical behavior

Corporate Governance and Compliance
Sources of Corporate Governance Requirements
– After Early 2000s Corporate Scandals – Highly Codified
  • Annual management report on internal control over financial reporting (Section 404 Report)
  • CEO and CFO certifications
    » Compliance with corporate governance requirements (Listing Requirements)
    » Periodic report compliance with ’34 Act (’906’ Certificate)
    » Fairly present financial condition and results of operations (’906’ and ’302’ Certificates)
    » Disclosure controls and procedures (’302’ Certificate)
    » Internal control changes and deficiencies (’302’ Certificate)
  • Restrictions on specified transactions with D&Os
  • SEC standards of professional conduct for attorneys
Corporate Governance and Compliance

Comparison of Model Rules and SEC Rules

<table>
<thead>
<tr>
<th>Model Rules</th>
<th>SEC Rules</th>
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<tbody>
<tr>
<td>• Up the ladder reporting permitted, but not required</td>
<td>• Up the ladder reporting is mandatory</td>
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<tr>
<td>• Actual knowledge is required to go up the ladder</td>
<td>• Credible evidence triggers the need to go up the ladder</td>
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<tr>
<td>• Substantial injury to the organization is required</td>
<td>• Substantial injury to the organization is not required – merely need “material violation”</td>
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<tr>
<td>• Permit attorney to disclose confidential information if highest authority fails to address an action or refusal to act that is clearly in violation of the law in a timely and appropriate manner and attorney reasonably believes that violation will reasonably result in substantial injury to the organization</td>
<td>• Permit attorney to disclose confidential information to the extent that attorney reasonably believes necessary to:</td>
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<td>- prevent Company from committing a material violation that is likely to cause substantial injury to the financial interests or property of Company or investors;</td>
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<td>- prevent Company from committing perjury, suborning perjury or committing any act that is likely to perpetrate a fraud on SEC; or</td>
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<td>- rectify consequences of material violation</td>
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Corporate Governance and Compliance

Sources of Corporate Governance Requirements

– After Early 2000s Corporate Scandals – Highly Codified
  • Public Company Audits (10A of ’34 Act, SEC Rules and PCAOB Rules)
    - Include procedures designed to provide reasonable assurance of detecting illegal acts that would have a direct and material effect on the company’s financial statements
    - Include evaluation of any illegal acts of which it becomes aware, inform management of such acts and assure that the audit committee has been appropriately advised of the matter
    - Inquire of management and the audit committee regarding the company’s compliance with laws and knowledge of violations or potential violations
    - Prohibits person acting at the direction of a director or officer from taking any action to mislead an auditor if such person knew or should have known that such action could result in rendering the company’s financial statements materially misleading

– After 2008 Financial Melt-Down
  • Dodd-Frank Reforms
    - Independence requirements for compensation committee members, advisors and counsel
    - Disclosure of whether or not company has separated or combined chairman and CEO positions
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Sources of Corporate Governance Requirements
– After 2008 Financial Melt-Down
• Dodd-Frank and SEC rules
  » Say on Pay – S/H non-binding vote at least once every three years on executive compensation, and a vote once every six years on the frequency (every one, two or three years) of say on pay s/h
  » Shareholder Proxy Access – Inclusion of a/h BoD nominees in company’s proxy statement (proposed SEC rule vacated by court and SEC not seeking a rehearing or appeal)
    » But, changes rules to require inclusion in proxy statements of shareholder proposals to amend charter or by-laws to change director nomination procedures which could provide for shareholder access to proxy to extent permitted by applicable state law
  » Compensation Clawbacks – Recovery of incentive-based compensation paid to executives during the three-year period preceding any restatement of financials due to any material non-compliance with SEC reporting requirements

Corporate Governance and Compliance
Sources of Corporate Governance Requirements
– After 2008 Financial Melt-Down
• 2010 Proxy Rule Changes
  » Disclosure of particular experience, qualifications, attributes or skills of each director or nominee that led the board to conclude that the person should serve as a director for the company
  » Disclosure of any directorships (public companies and registered investment companies) held by each director and nominee at any time during the past five years
  » Disclosure of nominating committee’s consideration of diversity in the process by which candidates for director are considered
  » Disclosure about a company’s board leadership structure
  » Disclosure about and the board’s role in the oversight of risk
  » Disclosure about the fees paid to compensation consultants

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Sources of Corporate Governance Requirements
– After 2008 Financial Melt-Down
• 2013 SEC Rule to Implement D-F Compensation Committee Independence Requirements – Require Exchanges to Change Listing Requirements
  » Independence – SOX definition, but must consider (a) any source of compensation paid to director from company (b) any affiliations with company or any subsidiary of company
  » Committee
    » Authority to independently hire compensation consultants, lawyers and other advisors
    » Must consider independence of advisors (other than for advisors that merely consult on broad-based plans or provide non-customized or issuer-specified information)
    » Directly responsible for hiring, firing, compensation and oversight of advisors
    » Company must provide sufficient funds
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Sources of Corporate Governance Requirements

– Oversight Cases

• Graham v. Allis-Chalmers (1963 Del.)
  » Derivative action arising out of losses suffered as a result of violation of anti-trust laws
  » Absent “red flag,” no BdD duty to install and operate a corporate system of "espionage" to ferret out wrongdoing which they have no reason to suspect exists

• In Re Caremark (1996 Del. Ch.)
  » Approval of settlement of derivative suit alleging breach of duty of care arising out of guilty plea in a Medicare/Medicaid kickback prosecution
  » Notes Federal Sentencing Guidelines
  » In order to satisfy obligation to be reasonably informed about the corporation, BdD must ensure:
    • Information and reporting systems exist
    • Reasonably designed to provide to senior management and to BdD timely, accurate information
    • Sufficient for management and BdD to make informed judgments w/r/t business performance and compliance with law
  » Plaintiff must establish sustained or systematic failure to exercise reasonable oversight
    • Utter failure to attempt to ensure a reasonable information and reporting system exists or, after “red flag,” failure to investigate or attempt to correct

– Business Judgment Rule – judicial deference to BOD actions – presumption that BOD acts in best interests of corporation and its s/h absent fraud, illegality or self-dealing

• DGCL 102(b)(7) – COI may eliminate or limit director personal liability to corporation of s/h for breach of fiduciary duty, except
  » Breach of duty of loyalty
  » Acts or omissions not in good faith
  » Intentional misconduct or knowing violation of law
  » For payment of illegal dividends/distributions
  » Any transaction from which director derived improper personal benefit

• Emerging duty of good faith (Cede v. Technicolor 1993; In re Disney 2006)
  » Requires subjective bad faith (actual/intent to do harm); or intentional deviation of duty, a conscious disregard for responsibilities
Corporate Governance and Compliance

Sources of Corporate Governance Requirements

– Oversight Cases

• Stone v. Ritter (2006 Del.)
  – Derivative suit arising out of fines paid for violation of banking and anti-money laundering laws
  – No separate duty of good faith
  – Oversight liability predicated upon breach of duty of loyalty
  – Otherwise upholds Caremark test
  ➢ Utter failure to implement any reporting or information system or controls
  ➢ Having implemented system or controls, conscious failure to monitor or oversee system or control and as a result disabling themselves from being informed of risks or problems
  ➢ Requires knowing failure to discharge fiduciary duties

  – Derivative and federal securities law suit arising out of subprime loan losses alleging that company disregarded own underwriting policies
  – Established scienter by showing that defendants were on the committees charged with oversight of risk exposures, loss reserves and investment portfolios
  – Publication of policies requires Bd and management to supervise compliance with policies or change policies
  – Case dismissed because plaintiffs lost standing as a result of merger with Bank of America

• In re Massey Energy (2011 Del. Ch.)
  – Action to enjoin merger with Alpha Natural Resources alleging that purchase price does not adequately value derivative actions arising out of Upper Big Branch mine disaster
  – Derivative claims allege failure to make good faith effort to ensure compliance with mine safety laws
  – Derivative claims likely to survive motion to dismiss
  – “Delaware law does not charter law breakers. Delaware law allows corporations to pursue diverse means to make a profit, subject to a critical statutory floor, which is the requirement that Delaware corporation only pursue ‘lawful business’ by ‘lawful acts.’ As a result, a fiduciary of a Delaware corporation cannot be liable to a Delaware corporation by knowingly causing it to seek profit by violating the law.”
  – Injunction declined
Corporate Governance and Compliance

Sources of Corporate Governance Requirements

– Federal Sentencing Guidelines

- To have an effective compliance and ethics program, a company must (1) exercise due diligence to prevent and detect criminal conduct and (2) promote an organizational culture that encourages ethical conduct and commitment to legal compliance

- Effective compliance and ethics program requires:
  - Board to be knowledgeable about content and operation of compliance and ethics program and exercise reasonable oversight of program
  - Senior management ensure that company has an effective compliance and ethics program
  - Specific person within senior management assigned overall responsibility for compliance and ethics program

Corporate Governance and Compliance

Sources of Corporate Governance Requirements

– Federal Sentencing Guidelines

- Effective compliance and ethics program requires:
  - Specific individual delegated day to day operational responsibility for compliance and ethics program
    - Report to senior manager having overall responsibility for program and as appropriate to Board or committee of Board
    - Adequate resources, adequate authority and access to Board or committee of Board
  - Company to periodically communicate standards and procedures and conduct training programs and disseminate information regarding program

Corporate Governance and Compliance

Sources of Corporate Governance Requirements

– Federal Sentencing Guidelines

- Effective compliance and ethics program requires:
  - Company must take reasonable steps to assure that program is effective
    - Monitor and audit criminal conduct
    - Evaluate effectiveness program periodically and assess risk of criminal conduct
    - Have and publicize system for Ee to report or seek advice regarding compliance or ethics issues anonymously, confidentially and without fear of retaliation
  - Company must respond appropriately to criminal violation
Corporate Governance and Compliance

Sources of Corporate Governance Requirements

– Federal Sentencing Guidelines

• To maintain mitigation if senior manager involved in wrongdoing:
  – Individual with operational responsibility for compliance and ethics program report directly to BoD or committee of BoD
  – Program detected offense before offense detected outside of company
  – Company promptly reported offense to proper authorities
  – No one with operational responsibility for program was involved in, condoned or was willfully ignorant of wrongdoing

– DOJ Filip Memorandum (2008)

• Existence of a compliance program is not sufficient, in and of itself, to justify not charging a corporation
• May consider whether the corporation has established corporate governance mechanisms that can effectively detect and prevent misconduct
  – Do the corporation's directors exercise independent review over proposed corporate actions rather than unquestioningly ratifying officers' recommendations?
  – Are internal audit functions conducted at a level sufficient to ensure their independence and accuracy?
  – Have the directors established an information and reporting system in the organization reasonably designed to provide management and directors with timely and accurate information sufficient to allow them to reach an informed decision regarding the organization's compliance with the law?

– Non-Prosecution and Deferred Prosecution Agreements
Corporate Governance and Compliance

Corporate Governance Players

– Institutional Investors

• Rise of institutional shareholders is big part of corporate governance story
• For most of history of corporations shareholders thought of as powerless
  - "small, dispersed, powerless and apathetic"
• Big push for corporate governance came with increased institutional ownership


Corporate Governance and Compliance

Corporate Governance Players

– Institutional Investors

• 1950 – 93% of stock held by individuals
• 2009 – 75% of stock held by institutional investors — nearly 80% of stock of 1,000 largest corporations held by institutional investors


Corporate Governance and Compliance

Corporate Governance Players

– Institutional Investors

• Increase in concentration of institutional ownership (i.e. less dispersion of ownership – fewer s/h holding a greater portion of stock)
• Increase in turn-over of stock
  - For most NYSE companies annual trading volume exceeds number of outstanding shares
Corporate Governance and Compliance

Corporate Governance Players
– Institutional Investors
  • Institutional stockholders are diverse
    – Different investment strategies and objectives
    – Different holding horizons
    – Some have social or political agendas

– Hedge funds and other private investors
  – Very short-term
  – 300% annual turn-over
  – E.g. Third Point (investment company that obtained Massey BoD representation in 2006)

– Mutual funds
  – Short-term
  – 100% turn-over

– Insurance companies
  – Long-term

– Pension plans
  – Long-term
  – Diverse – Public, union, private, etc.
  – Many have social and political agendas
  – E.g. New York State Common Retirement Fund, CalSTERS and CtW Investment Group (group that worked with union sponsored pension plans) who were active in the Massey situation
Corporate Governance and Compliance

Corporate Governance Players
- Institutional Investors
  - In general, pension plans have been the most active in pushing “good” corporate governance agenda
    - Long-term ownership
    - Social and political agendas
  - Although other types of institutional stockholders have become activists pursuing specific short-term economic goals (e.g. Carl Ichan; Third Point in the Massey situation)

- Results
  - Decline in structural defenses (e.g. staggered or classified board)
  - Decline in companies with poison pills
  - Increase in percentage of independent directors on BoD
  - Increase in number of companies with majority voting requirements (less than 20% in 2006; more than 70% in 2010)
  - Increase in corporate governance rules

Corporate Governance and Compliance

Corporate Governance Players
- Proxy Advisory Firms
  - Part of story of rise of institutional shareholders
  - Growth of institutional investment
    - 1950 – 93% of stock held by individuals
    - 2009 – 75% of stock held by institutional investors – nearly 80% of stock of 1,000 largest corporations held by institutional investors
Corporate Governance and Compliance

Corporate Governance Players
- Proxy Advisory Firms
  - Nearly 100% of shares held by institutional shareholders are voted
    - Many institutional shareholders have fiduciary obligation to vote shares
      - 1994 DOL interpretation of ERISA requires votes for shares owned by ERISA retirement and pension plans
      - 2003 SEC regulations require investment companies and investment advisors to adopt policies and procedures to ensure that shares are voted in best interests of shareholders and clients
  - Institutional shareholders hold positions in large number of companies
    - Therefore, lots of votes
      - Nearly 4,500 public companies hold annual meetings
      - Exxon Mobil 2010 annual meeting – election of 11 directors and 11 shareholder proposals
      - TIAA-CREF casts more than 80,000 different votes every year
  - Institutional shareholders typically hire investment advisor to manage investments
    - May or may not delegate authority to vote

Corporate Governance and Compliance

Corporate Governance Players
- Proxy Advisory Firms
  - Analysis and voting recommendations
  - Development of proxy voting policy
    - Sometimes specific to client
    - Sometimes merely adoption of advisor's guidelines
  - Sometimes authority to vote
  - Corporate governance research
  - Administrative tasks
  - Help mitigate institutional shareholder conflicts of interest
Corporate Governance and Compliance

Corporate Governance Players

- Proxy Advisory Firms
  - As a result, proxy advisory firms have significant influence in corporate elections

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Corporate Governance Players

- RiskMetrics (ISS)
  - 61% market share
  - Clients own approximately 20 to 30% of a midcap or largecap companies' outstanding shares
  - Owned by MSCI, Inc., a public company that provides a wide range of services to institutional investors and corporations

- Glass Lewis
  - 37% market share
  - Clients own approximately 5 to 10% of a midcap or largecap companies' outstanding shares
  - Owned by Ontario Teachers' Pension Plan which engages in public and private equity investing

Corporate Governance and Compliance

Corporate Governance Players

- Proxy Governance, Inc.
  - Owned by firm whose chief subsidiary is a registered broker-dealer

- Egan-Jones
  - Owned by a firm whose primary business is a credit ratings agency

- Marco Consulting
  - Clients are primarily union pension funds

- CtW Investment Group
  - Clients are primarily union pension funds
Upper Big Branch Mine disaster
April 5, 2010

“If any of you have been asked by your group presidents, your supervisors, engineers or anyone else to do anything other than run coal (i.e. – build overcasts [part of ventilation safety system], do construction jobs, or whatever), you need to ignore them and run coal. This memo is necessary only because we seem not to understand that the coal pays the bills.”

CEO memorandum to mine superintendents
October 19, 2005

– 2000
- Formed as a result of the separation of Fluor Corporation’s coal-related businesses from its non-coal-related businesses
- First of many calls for Blankenship (CEO) to resign
  - Confrontational approach to regulators, shareholders, and workers and emphasizing production over safety
– 2006
- Two representatives of Third Point (hedge fund) elected to BoD in proxy contest
  - Expands BoD to retain defeated directors
Corporate Governance and Compliance
The Massey Energy Saga
– 2007
  • Third Point representatives resign from BoD
    » Cites confrontational handling of regulatory and environmental matters
    » Indicates that company trades at a “Blankenship Discount”
  • Derivative suit filed claiming damage to company as a result of lax attitude regarding worker safety and environment
    » Settlement – Revamp BoD safety and environment committee and appoint new safety and environmental managers and annual BoD social responsibility report

Corporate Governance and Compliance
The Massey Energy Saga
– 2008
  • Pays record fines for worker and safety violations
– 2009
  • Forms BoD committee to look into s/h inquiries regarding safety
  • Safety violations more than double since 2005
  • Glass Lewis gives “C” grade citing executive compensation and “vague and incomplete disclosures” regarding transactions with Ds&Os

Corporate Governance and Compliance
The Massey Energy Saga
– 2010
  • S/H proxy proposals
  • UBB Disaster
  • Amends corporate governance guidelines to require resignation of director who receives more withhold votes than for votes in an uncontested election
  • Pays record fines for worker and safety violations
  • A director resigns (59% withhold vote in 2009 elections)
  • BoD vote of confidence for Blankenship
  • Several derivative suits filed
Corporate Governance and Compliance
The Massey Energy Saga
– 2010 (cont.)
• S/H campaign to “withhold” and to declassify BoD
  » CtW
  » New York State Common Retirement Fund
• Glass Lewis and RiskMetrics recommend opposing
director nominees
• CalSTRS letter

Corporate Governance and Compliance
The Massey Energy Saga
– 2010 (cont.)
• Annual meeting
  » Record participation (85.4%)
  » Reelection of three directors (55.09 – 57.83%)
  » Majority voting (63.91%)
  » Declassification of BoD (95.08%)
  » BoD announces amendment to By-Laws to implement majority
voting and that it will submit proposal to stockholders for
amendments to certificate of incorporation
• Appointment of two new independent directors who are
appointed to the special litigation committee

Corporate Governance and Compliance
The Massey Energy Saga
– 2010 (cont.)
• Proposals to be submitted at special meeting
  » Declassification of the BoD
  » Elimination of cumulative voting
  » Removal of supermajority vote provisions related to stockholder
approval of business combinations with more than 5% stockholder
  » Removal of the prohibition of the right of stockholders to
request special meetings of stockholders
• ISS and Glass Lewis recommend vote “for” governance
proposals
Corporate Governance and Compliance
The Massey Energy Saga
– 2010 (cont.)
  • Special meeting
    » Approved BoD declassification, removal of supermajority vote for stockholders to amend By-Laws, removal of supermajority for approval of certain business combinations, removal of prohibition on stockholder right to request special meeting of stockholders and increased authorized shares to 300,000,000
    » Did not approve elimination of cumulative voting (received 74%, but needed 80%)
  • Dodd-Frank requires disclosure regarding mine safety "imminent danger" orders
  • Blankenship announces plan to retire and successor

Corporate Governance and Compliance
The Massey Energy Saga
– 2011
  • Announces agreement with Alpha
  • Court rejects request to enjoin Alpha transaction
  • Shareholders approve sale
  • Alpha non-prosecution agreement
– 2012
  • Criminal charges brought against president of Green Valley Coal Company, a division of Massey, arising out of UBBM